

SPECIFIC COMMENT REQUESTS

Substitute Check Definition

The Board particularly requests comment on the proposed commentary to the substitute check definition that describes the various ways in which the MICR line of a substitute check can vary from the MICR line of the original check. First, the commentary notes that ANS X9.90 requires the content of position 44 of the MICR line of a substitute check to vary from that of position 44 of the original check to ensure that the check image remains constant if more than one substitute check is created to represent the same original check.

The use of ANS X9.90 which requires a 4 or 5 in position 44 of the MICR line would appear to be adequate to identify substitute checks. However, we have concerns that this will ensure the size of the check image will remain constant. (see other comments)

Second, the commentary acknowledges that the original check could have an encoding error in the amount field (including a failure to encode) and that a substitute check that reproduces that error would meet the definition of a substitute check. However, the commentary notes that a reconverting bank that creates a substitute check from an original check with a misencoded amount field or a bank that handles a substitute check that perpetuates the amount encoding error may repair the MICR line to facilitate the processing of the check without changing the item's status as a substitute check. This approach would be consistent with the current industry practice of allowing a bank to repair the MICR line of an original check when the bank detects an encoding error in the amount field.

Repairing encoding errors should facilitate processing of substitute documents. Since a substitute check is the legal equivalent of the original check and this is a common practice with original checks, we believe this should be allowed for substitute checks.

Third, the commentary notes that the MICR line of the original check could be accurate in every respect but that check imaging equipment could (1) fail to read a portion of the MICR line but note the presence of MICR information with an asterisk, (2) misread a digit in the MICR line, for example by reading an "8" as a "3," or (3) intentionally read a space or a placeholder, such as a hyphen, to be a "0." These errors collectively are referred to as MICR-read errors. To ensure that the items a bank transfers in reliance on the Check 21 Act and subpart D meet the definition of a substitute check, the commentary states that before a reconverting bank creates a substitute check it should correct all MICR-read errors. The proposed commentary would clarify that an item that perpetuated a MICR-read error would not be a substitute check as defined in § 229.2(zz). However, as discussed in connection with § 229.51(c) of the proposed rule and the proposed commentary to that section, the Board proposes that, when such a noncompliant item purports to be a substitute check, the substitute check warranties, indemnity, and recredit rights would apply to that item as if it were a substitute check, even though it would not be the legal equivalent of the original check. The Board proposes this approach in order to facilitate compliance with and prevent circumvention and evasion of the Check 21 Act.

Because the Check 21 Act requires all substitute checks must be machine readable, repair of the MICR line is necessary. Any repair of the MICR line should duplicate the MICR line of the original check exactly. If an original check experiences a MICR-read error, it is common industry practice to only repair the necessary fields to complete processing. For example, the ABA number and

amount may be corrected, but the account number and check number may not be corrected. Because of the reliance of the MICR information under the Check 21 Act, it is imperative that all MICR data duplicate the information on the original item completely and accurately.

An item that perpetuates a MICR read error or otherwise is noncompliant but purports to be a substitute check, should carry the warranties, indemnity and recredit rights as if it were the legal equivalent of the original check.

Indorsement Standards

The Board requests comment on all aspects of the proposed indorsement and identification standards.

While the proposed rules seem clear, we are concerned that adding additional symbols and endorsement locations will further complicate a process that is already prone to error and misrouting. Existing indorsement standards are not followed or enforced effectively. Indorsements are difficult to read and items are frequently misrouted. Automated systems often route returned items to the sending point rather than the bank of first deposit.

Additional indorsements and symbols on substitute checks will complicate an already complex and inefficient process. Allowing returning banks the flexibility to indorse items on the front would potentially create more confusion. Indorsement locations should be standardized.

Legal Status of Substitute Checks that don't meet all requirements

The Board requests comment on whether an item that fails to meet any of the other the substitute check requirements in § 229.2(zz) also should be treated as though it were a substitute check for those limited purposes.

A bank should not be exempt from providing the warranty and indemnity protections afforded by Check 21 by failing to meet one of the requirements for a substitute check. If an item is presented that purports to be a substitute check, the receiver should have all the warranty and indemnity rights under the Check 21 Act.

Should reconverting banks continue to present items that do not meet the legal requirements of a substitute check, receivers should have the right to refuse to accept these items. Once the Check 21 Act is implemented, this may become an issue that will need to be revisited.

Warranty against duplicate payments

The Board specifically requests comment on whether using information from a check to create an ACH debit entry should be a payment request covered by this warranty.

Current NACHA rules and Regulation E cover the conversion of a check to an electronic transaction. Because a substitute check is the legal equivalent of the original check, there does not appear to be a reason to specifically address conversion to ACH in Regulation CC.

Business day vs. banking day

In addition, the statute measures time from the "business day" (defined as any day, other than a Saturday, Sunday, or legal holiday) on which the bank received a claim. However, the Board proposes to incorporate the term "banking day," as it has for other parts of Regulation CC. Banking day means "that part of any business day on which an office of a bank is open to the public for carrying on substantially all of its banking functions." The

Board believes that “banking day” is an appropriate term when referring to the time at which a bank must begin measuring the time period for action. The Board requests comment on both of these adjustments relating to time period calculations.

We believe that using business days is the most appropriate for calculating time periods for an expedited recredit claim. Banking days generally refer to “retail operations” such as teller functions, loan processing, etc. Back office functions such as item processing, image retrieval and research functions generally operate on business days, not banking days. If the banking day calculation is used, a bank could lose 1 – 3 days while making the determination if a claim is valid.

Expedited recredit claims

The Board requests comment on whether or not its proposed reorganization of the statutory provisions regarding action on claims is an improvement over the statutory organization and encourages commenters to provide specific organizational suggestions.

The proposed organization of the provisions regarding action on claims is adequate.

The proposed rule would allow the bank to reverse both the amount it previously recredited plus any interest that it has paid on that amount. The statute does not explicitly address the reversal of interest when reversing a recredit, and the Board specifically requests comment on whether the proposed approach is appropriate.

If a recredit is reversed, the reversal of interest (if any) that was paid on the recredited amount is appropriate.

The Board requests comment on whether additional commentary to § 229.54 would be useful and, if so, what specific points should be covered.

Additional commentary does not seem necessary at this time.

Consumer awareness disclosures

The Board therefore has proposed two alternative rule provisions regarding when a bank must provide the disclosure to a consumer who requests a copy of a check. One alternative tracks the statute and requires a bank to provide the disclosure at the time of the request, but the other alternative requires provision of the disclosure at the time the bank provides the substitute check to the consumer. The Board specifically requests comment on which of these alternatives is preferable.

We believe it would be most appropriate to provide the disclosure at the time a substitute document is presented.

The Board requests comment on whether the proposed model disclosure is clear, accurate, and concise.

Model disclosures are adequate.

The Board specifically requests comment on whether providing model language for the § 229.54(e) notices is useful.

Providing model notices is helpful, especially for institutions that do not have resources to develop disclosures and notices internally.

Non Check 21 Clarifications

The proposed amendments seem appropriate for the current processing environment.

The Board also requests comment on whether there are circumstances under which it would be appropriate to reduce the time frame for providing a notice of nonpayment.

Reduction of the time frame for providing notice of nonpayment would not be appropriate at this time.

Reference to Industry Standards

The Board requests comment generally on the desirability of this approach and specifically on whether commenters would prefer that the Board identify specific industry standards within the text of the rule.

The reference to applicable industry standards would seem adequate. We do not find it desirable to refer to specific industry standards in the text of the rule. It may be appropriate to refer to the types of standards without out listing the specific standard.

Relationship to other law

The Board specifically requests comment on whether the proposed commentary is adequate with respect to the interaction between the Check21 Act and existing law or whether commenters believe that additional discussion and examples are needed.

We have concerns about how this will affect state and local laws related to checks, check fraud, etc. It is difficult to be specific at this time. However, we find the warranties and indemnities to be troublesome and create new opportunities for abuse of the payment system increasing the burden on the bank.

Incorporate UCC Revisions

The Board requests comment on whether it would be appropriate to incorporate the U.C.C. revisions into Regulation CC.

Since the revision has not been adopted by all states, or even a majority of states, it would not seem appropriate to incorporate the U.C.C. provision into Regulation CC.

Plain Language

The Board requests comment on whether it could make the proposed regulatory language clearer and, if so, how.

No Comment

Paperwork Reduction Act

The Federal Reserve specifically requests comment on these burden estimates as described above.

No Comment

Regulatory Flexibility Act

The Board specifically requests comment on the impact of the proposed rule on small banks.

We believe that substitute checks introduce a new payment instrument that can be used to commit fraudulent acts. Small banks do not have the resources to develop fraud prevention techniques to work in an electronic exchange/substitute check document environment. While this potential risk cannot be quantified, we believe it could become overly burdensome.

OTHER COMMENTS

229.55 Expedited recredit procedures for banks - timing of claim

The claimant bank must submit its claim to the indemnifying bank by the end of the 120th calendar day after the date of the transaction that gave rise to the claim.

Since the consumer has 40 days to file a claim for a recredit, the claimant bank time frame of 120 days seems unnecessarily long. Since the Check 21 Act does not address retention period for original items, institutions will evaluate retention of originals based the risk associated with needing to produce an original or sufficient copy. We believe a shorter period of time would be appropriate.

229.56 Liability - notice of claims

Except as otherwise provided in this paragraph (d), unless a person gives notice of a claim under this section to the warranting or indemnifying bank within 30 calendar days after the person has reason to know of both the claim and the identity of the warranting or indemnifying bank, the warranting or indemnifying bank is discharged from liability in an action to enforce a claim under this subpart to the extent of any loss caused by the delay in giving notice of the claim. A timely recredit claim by a consumer under § 229.54 constitutes timely notice under this paragraph.

To be consistent with the time frame for a consumer expedited recredit claim, this should also be 40 calendar days.

Abuse of recredit claims

We are concerned that consumers may abuse expedited recredit rules. A consumer could use recredit claims to fund account(s) that would not otherwise have sufficient funds to cover account activity. This would cause an undo hardship on banks (particularly small banks) that would be required to repeatedly process recredit claims that would ultimately prove to be invalid.

Fraudulent Substitute Checks

Substitute checks do not look significantly different than a photocopy. Although they are required to have MICR ink, it will be very difficult for a teller to determine if MICR ink is present and distinguish a photocopy of a substitute check from an authentic substitute check. As mentioned above, we are very concerned about the potential for increased fraud and the disparate impact this may have on small banks.

Substitute Check Quality and Size

The proposed rules address substitute checks being reconverted more than once. However, once a substitute check is processed and imaged, the size of the image will be fixed in the image archive. If the substitute check is subsequently returned and the image from the archive is transmitted to the reconverting bank, the image will be again reduced when the substitute document is printed. Because the only image available is that of a substitute check and not the original check, the size will be reduced. The same inadvertent reduction in size could occur if a substitute document is damaged during processing and placed in a document carrier.

Additional commentary may be necessary to address these issues.

